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RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

UNCLAS SECTION 01 OF 02 DUBAI 000012

SENSITIVE

DEPARTMENT FOR NEA/ARP BMASILKO

SIPDIS

E.O. 12958: N/A
TAGS: EFIN ECON EINV ETRD PGOV AE
SUBJECT: DUBAI'S REAL ESTATE PRIMER

REF: 07DUBAI2878

DUBAI 00000012 001.2 OF 002

¶1. (SBU) Summary. A substantial portion of the Dubai real estate boom (and subsequent bust) was fueled by regional excess liquidity, negative real interest rates, and speculators and longer term investors riding the rocketing price wave. However, the Dubai market differs substantially from the typical U.S. real estate market, and it is these differences that put the sector at risk in the current economic environment. The following is a basic primer in the uniquely Dubai factors (some of which spread to neighboring Abu Dhabi): the "off-plan" sale, the high numbers of speculators rapidly flipping units, and long-term investors eschewing rental income on completed units. It is these three factors that will most likely exacerbate the pain felt if and when the Dubai real estate dream bursts. End Summary.

Buying "off-plan"

¶2. (SBU) When Dubai opened property ownership to expatriates in 2002, it was in newly designated "free zones," completely devoid of existing housing stock. Developers, anxious to cater to the pent-up expat demand, started offering eager buyers the opportunity to purchase their apartment or villa "off plan" (based on architectural drawings and plans for buildings that had not yet broken ground). These developer-financed contracts typically required small down-payments, as low as five to ten percent of the purchase price. As time milestones (and more recently, construction milestones) pass, buyers are required to make additional percentage payments on the contract, culminating with a final payment once the unit is completed and turned over. While there is some turn-over in completed homes and apartments, the vast majority of Dubai real estate deals, up until late 2008, were for developer financed "off-plan" units. In turn, most of the developers secured funding through project financing deals at local banks (using the land and other assets as collateral).

Rise in speculation

¶3. (SBU) With the rising price of oil in 2005, loose international credit policies, and foreign capital inflow (falsely) anticipating a de-pegging of the dirham, liquidity flowed into the Gulf and into the various Dubai developers' projects, pushing prices up at escalating rates. Speculators, recognizing an opportunity, started buying highly leveraged property with minimal down-payments, intending to resell the unit before additional payments were required. For example,

invest 100,000 AED as the 10 percent down-payment on a one million AED property, and if the price goes up ten percent, to 1.1 million AED before the additional payment was required (a common occurrence in the 2005 to early 2008 market), a speculator selling the unit at the new price cleared 100,000 AED profit on the 100,000 AED investment - not bad for a short-term investment. During 2006 and 2007, it was not uncommon to hear of off-plan sales events selling out within one of hour opening and units being flipped at a substantial profit within the same day.

Holding onto an investment

¶4. (SBU) Not only did speculation hype demand, legitimate investors also exacerbated the problem by keeping completed units vacant, neither leasing nor re-selling them. In fact, overall "new Dubai" occupancy rates mid 2008 were estimated at 65 percent, with some new luxury developments like the 40 building Jumeirah Beach Residence complex only 45 percent occupied. With double digit annual rent and sales price inflation, investors were reluctant to lease or sell, afraid that they might not have yet ridden the market to its peak. Under Dubai's rent cap law (reftel), yearly maximum rent increases were limited to five percent per annum in 2008. Once a unit is leased, the contract remains valid even if the unit is sold, and it is relatively difficult to legally evict a tenant. For this reason, occupied/rented units sold at greatly discounted prices compared to similar vacant units. Some investors were willing to forego several years' rental income in anticipation of bigger ultimate returns.

¶5. (SBU) What remains unclear is who owns the unoccupied units and why they continue to be held off the market. As detailed above, some are held by long-term investors following a profit maximization strategy. Others are held as legitimate second homes: conveniently located near Iran, Pakistan and other less

stable countries, common lore is that many of the units are "bolt-holes", purchased for their accompanying residency visa and as an asset safe-haven. However, local rumors from well informed sources have also speculated that up to 70 percent of these units are held by the Dubai government, Dubai parastatals, the Al Maktoum family or other influential families/businesses. The underlying rationale being that the units were initially held off the market to drive up prices and now are being held off to keep the market from entering a free fall.

Comment

¶6. (SBU) As 2008 came to a close, the market for off-plan, flipped units evaporated. Speculators are scrambling to make the next payment installments or, increasingly, simply walking away (while actual default numbers are not available, anecdotally a local newspaper recently reported that over 3,000 cars have been abandoned at UAE airports - an indication that expats, increasingly unable to cope with unemployment and debt levels, are simply abandoning their financial obligations and heading home). Whether long-term investors will start liquidating their investments is still unclear; however, rental prices are starting to fall, suggesting either excess supply (investors renting their units), decreased demand (unemployed expats are departing the UAE) or, as is more likely the case, both. The medium term implications could be severe, as a housing glut exacerbated by increasing unemployment and increasing loan defaults could trigger even further pull back an economy already at risk. End Comment.

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